

I.P. Due Diligence in a Sale: Probing the Status of Intellectual Property Assets

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BUYING OR merging companies in today's environment is difficult enough without having to worry about ownership of all intellectual property assets. Yet in many transactions, the intellectual property assets of a company may be the most valuable assets in the acquisition. These intellectual property assets take many forms: the computer programs the seller uses to run its business, either those in which the seller claims ownership or has licensed from third parties; computer program documentation; customer lists; distribution channels; processing methods; business plans; and manufacturing methods. This article focuses on some of the copyright considerations when dealing with intellectual property asset transactions.

Failure to properly deal with the intellectual property assets in the acquisition of a company can create liability for the buyer or the successor entity in the merger or acquisition. In addition, even the best business plans for post-merger or acquisition activities can go awry when a third party unexpectedly makes an ownership claim to an intellectual property asset, or when the buyer discovers that he has fewer rights to use the intellectual property than originally believed. Such claims can significantly affect the financial and legal health of the organization.

One method of avoiding or minimizing liability is through a proper due diligence review of the intellectual property assets of the subject business as a condition of closing the deal. Such an undertaking will entail an examination of the various intellectual property assets of the business and a report on their legal status. The due diligence investigation of intellectual property assets in acquiring a business or merging companies demands a thorough examination of the chain of title for the ownership claim. Unlike real estate, where the chain of title may be searched through the local Recorder's Office, title records to intellectual property assets are more difficult to obtain or establish. However, just as clear title to real property assets is important to a business, clear title to intellectual property is important as well.

As part of the due diligence review of the buyer, competent legal counsel needs to evaluate and advise the buyer company about the legal rights and risks attendant to the continued use of computer programs and other intellectual property assets.

Affiliated companies that undergo reorganization or merger must also address a due diligence review of the relevant intellectual property assets in order to minimize potential liability. In the case of *Data Products Inc. v. Reppart*, No. 89-1291-K, 1990 U.S. Dist. LEXIS 16330 (D. Kan. Nov. 29, 1990), Sunflower Telephone Co. (Sunflower) acquired from Data Products Inc. (DPI), plaintiff, two different

computer program packages: (1) LCBA Telephone Accounting System and Payroll System (TAS), acquired in 1980 and (2) TAS for Cable (alternatively known as DPI CATV Accounting System), acquired in 1982. Sunflower's agreement with DPI provided that Sunflower could use TAS for one of its subsidiaries and TAS for Cable for another.

Several years later, ST Enterprises Inc. (ST) was formed and many of the companies affiliated with Sunflower underwent reorganization or mergers. Under a management agreement, ST began providing payroll, accounting and billing services for the newly formed entities. In order to fulfill these obligations, the president of ST instructed an employee of one of the subsidiaries to use the DPI computer program packages. In addition to this "internal" use of the DPI software, employees of one of the subsidiaries installed the DPI software on a computer owned by one of ST's customers. DPI learned of this activity and filed a lawsuit against Sunflower, ST and several of the officers and employees of the related companies. DPI alleged breach of contract and copyright infringement.

The court noted that the language of the agreement between DPI and Sunflower was ambiguous. The ambiguity centered on whether the 1980 agreement was a purchase or license. Claiming the agreement was a purchase, the defendants argued that the "first sale" doctrine of copyright provided a defense to some of their activities. See 17 U.S.C. § 109(a) (1988).

The court quickly dismissed this argument, as well as defendants' other arguments, in response to defendants' motion for summary judgment. The court noted that, even assuming the agreement was a purchase, the defendants' argument was invalid. The court stated that:

[u]nder the first sale doctrine, the distribution rights accorded to the holder of the copyright in any given copy of the copyrighted material are extinguished upon the transfer of title to the copy. The purchaser may then alienate that particular copy of the copyrighted material to another party without violation of the copyright laws.... However, this right on the part of the purchaser only extends to the transfer of the original copy; it does not extend to the making of unauthorized copies of the material.... Even after the sale of an item under copyright protection, the owner of the copyright retains the right to prevent the unauthorized copying or manufacture of derivative works (citations omitted).

The Data Products court noted that even assuming the 1980 agreement was a sales contract and that title to a copy of the program package passed to Sunflower, DPI relinquished only the right to distribute that particular copy of its computer program package. The court found no support in the copyright law for the defendants' activities of copying the programs, modifying them, and using the programs for other services (i.e., for third parties).

The Data Products case also shows that one factor which may give management additional incentive to undertake proper due diligence in the securing of intellectual property assets in a merger or acquisition is the potential for individual liability of an employee for copyright infringement. An employee (e.g., officer or director) can have his or her personal assets at risk in the joint and several liabilities that can arise from a copyright infringement. Concerning the liability of the individual employee defendants, the Data Products court noted that "[e]ach of the individual defendants was an officer and shareholder in the various corporate defendants. Each had the right to supervise the infringing activity and each had a financial interest in that activity. As a result, ***each may be held jointly and severally liable for any infringement of DPI's copyrights. . . . This is true even if the individual defendants did not have 'active supervision' of the employee committing the infringement ... and were in fact ignorant of the infringing activity....***" (Citation omitted) (Emphasis added).

Under the right circumstances, the individual corporate executives putting the deal together could potentially be held personally liable for the infringement of third-party copyrights (and possibly other causes of action as well).

In planning for the merger or acquisition, the parties should consider many questions designed to probe the status of the intellectual property assets. These questions include:

- Have all the intellectual property assets been identified and listed?
- Have original registration certificates been produced and examined (for example, copyright, trademark, or patent registrations)?
- Once the company's intellectual property assets have been identified, do any other intellectual property assets exist that would affect the transaction (for example, third-party computer programs, or trademarks in use for which no certificate was provided)? If so, have the sources of these other intellectual property assets been ascertained and the rights of use analyzed?
- Have all license agreements between the company and third parties been examined? Are there any apparent breaches of the license or any in the making?
- Have all transfers of intellectual property assets from third parties been verified and filed?
- Have all security interests in any intellectual property been perfected? Have all instruments of perfection been reviewed and verified?

- Have all non-disclosure and confidentiality agreements with third parties been obtained and reviewed?
- Have all non-disclosure and confidentiality agreements with employees been obtained and reviewed? Are any employees subject to non-disclosure agreements with third parties (i.e., a prior employer)?
- Have all agreements with independent contractors been reviewed to verify their impact on the company's intellectual property assets?
- Are there any pending or potential lawsuits concerning the intellectual property assets? If so, have the details been thoroughly investigated and analyzed?

There are other questions to consider and numerous other examples in which a proper due diligence undertaking could prevent potential liability or a loss of intellectual property rights.

The issues can be complex and detailed. However, if the intellectual property assets are important to the buyer or to the successor company, then the due diligence undertaking by knowledgeable counsel that can help prevent or minimize the downside risks is a sound investment in the future value of the company.